



# TD Economics

## Special Report

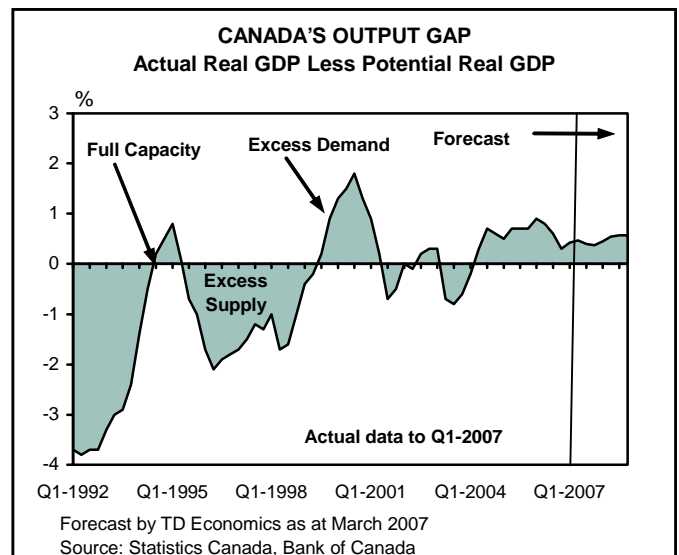
May 28, 2007

### BANK OF CANADA RATE HIKES COMING: IF NOT TOMORROW, THEN SOON

Of 20 dealers surveyed by Bloomberg, none expect the Bank of Canada to change its key policy interest rate tomorrow and almost all predict the Bank will remain on hold through September. TD sees things differently. We are alone in calling for a 25 basis point hike in July and another in September, which would take the rate to 4.75 per cent. The reasons for this off-consensus position cut to the heart of the monetary policy challenge. Weak productivity growth means that the Canadian economy cannot expand strongly without compromising the Bank's 2 per cent inflation target. Consequently, the Bank of Canada must tighten the dial on monetary conditions. The recent rise in the Canadian dollar is doing some of the lifting, but in good part this is a reflection of strength in the Canadian economy, particularly through high commodity prices. Higher interest rates will also be required to cool inflation pressures.

#### Canadian economy in excess demand

Despite weak growth through much of 2006, the Bank of Canada estimated that by the end of the year the Canadian economy was operating slightly above its capacity limit. As recently as its April 2007 Monetary Policy Report, the Bank had predicted relatively weak economic growth in the first two quarters of 2007 and expected this to wring out much of the excess demand and hence dampen inflation pressures. It is now clear that GDP growth in the first quarter was stronger than 3 per cent and the hand-off to the second quarter suggests that the Bank's growth expectation will once again be exceeded. TD estimates that



the Bank of Canada's main measure of capacity pressure will show significant excess demand at the end of the second quarter. As the Bank acknowledges, this measure should not be interpreted as having a high degree of precision. But actual and anecdotal information support the notion of capacity pressures.

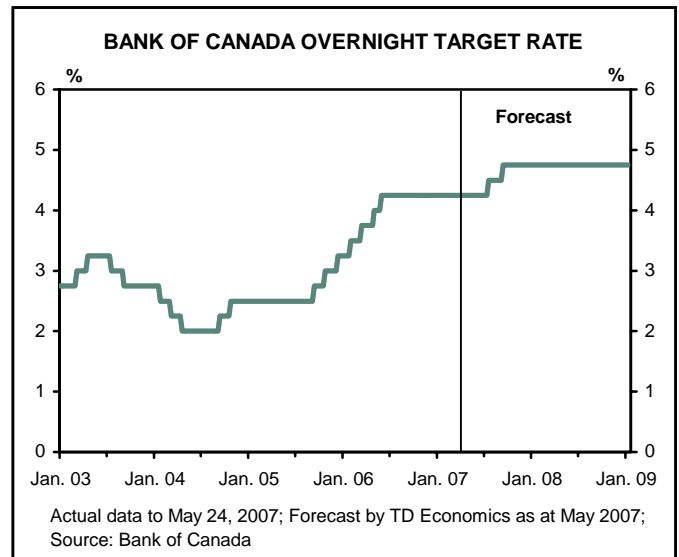
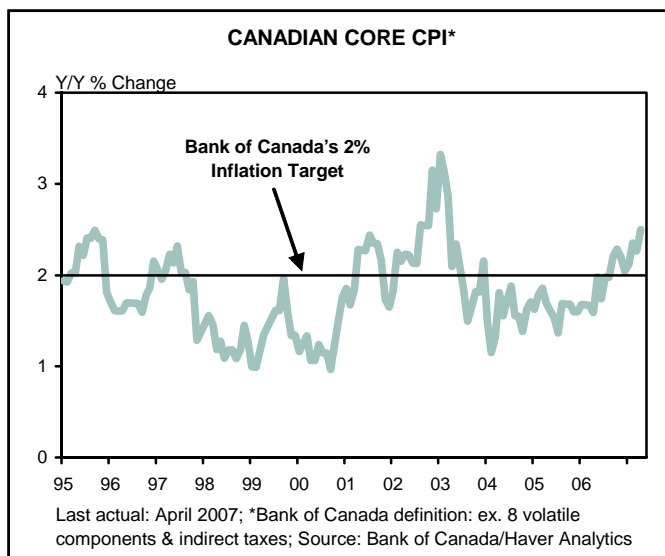
#### The Bank's inflation target has been breached

As described in TD's Monetary Policy Monitor of May 24 (<http://www.td.com/economics/finances/mpm0507.pdf>), the core rate of CPI inflation, being the total excluding the most volatile items, is running at 2.5 per cent, one-half point above the Bank's target. The only other time the target has been significantly breached

was 4 years ago and the pressure was largely, but not exclusively, concentrated in a few specific items where the inflation quickly receded. Still, the Bank did jack up interest rates at that time, only to bring them back down later as some economic slack was generated. This time the inflation pressure is pervasive. The core rate of inflation for services, abstracting from the dampening effect of last year's GST rate cut, is running at 3 ½ per cent and the disinflationary influence on goods prices from prior exchange rate appreciation and low cost imports from Asia is waning. Labour and capital shortages are being experienced in many parts of the country, even where, as in Central Canada, overall growth has not been robust.

Current inflation pressures could possibly abate without a tightening of monetary conditions. The retrenchment of the U.S. housing sector has yet to run its course and this could spill over to weaker consumption spending and soften demand for Canadian exports. The recent rise in the Canadian dollar could dampen Canadian growth, particularly through weak exports of manufactured goods. And a softening of surging housing prices in the West would dampen the housing component of the CPI. These are all conjectures. Moreover, to some degree all these downside risks are reflected in the TD Economics forecast and still the economy remains in excess demand through 2008 under current monetary conditions.

The condition of excess demand and a breached inflation target is reality. To be sure, monetary policy must be forward looking. But if the current pace of inflation gets embedded in inflation expectations it will be hard to eradi-



cate. The Bank of Canada has earned a high degree of credibility for meeting its target. That credibility would be eroded if it allowed inflation to exceed its target for a lengthy period without responding.

### Something seems terribly wrong with this picture

We must stand back from the current challenge before the monetary authorities and consider that something is very wrong with this economic picture. The Bank of Canada is saying that based on its assessment of trend productivity growth, the Canadian economy cannot grow faster than 2.8 per cent per annum without compromising the inflation target. In the near term growth must be even weaker to remove the excess demand. Worse, we expect the Bank of Canada to again revise down the estimated speed limit for the economy because Canada's actual productivity performance has been falling short of their estimate of trend growth for quite some time. The result may well cap growth in the economy to 2 ½ per cent per annum or possibly even lower. If Western Canada continues to grow faster than the average then this bodes poorly for Central and Eastern Canada being able to break above a 2 per cent pace of growth.

### Canada needs a concerted, national effort to bolster productivity growth

There's not much the Bank of Canada can do to bolster Canada's pathetic productivity performance of late other than maintaining low, stable inflation. Other agents of the economy, in the public and private sectors, need to mount

a concerted effort to turn around the situation. For years we have been hearing dire warnings that as the baby boomers retire Canada will slip into a lower growth path. Sadly, we're there now.

Nobody may be expecting the Bank of Canada to raise its interest rate tomorrow. But they would be justified in

doing so. And if they don't act tomorrow, they will need to soon. Many actors in the economy will understandably be upset. If the angst could be directed at efforts to mount a concerted, national effort to drive up productivity growth every Canadian would be better off.

*Don Drummond*  
*SVP & Chief Economist*  
*416-982-2556*

*Marc Lévesque*  
*Chief Economics Strategist*  
*TD Securities*  
*416-982-8785*

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